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TAX TREATMENT OF CERTAIN TRANSFERS OF PROPERTY TO FOREIGN CORPORATIONS

December 16, 1970.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

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Mr. Mills, from the Committee on Ways and Means, submitted the following

REPORT

[To accompany H.R. 19686]

The Committee on Ways and Means, to whom was referred the bill (H.R. 19686) to amend section 367 of the Internal Revenue Code of 1954, having considered the same, report favorably thereon with an amendment and recommend that the bill as amended do pass.

The amendment is as follows:

Strike out all after the enacting clause and insert the following:

That (a) section 367 of the Internal Revenue Code of 1954 (relating to foreign corporations) is amended to read as follows:

"SEC. 367. FOREIGN CORPORATIONS.

"(a) General Rule.—In determining the extent to which gain shall be recognized in the case of any of the exchanges described in section 332, 351, 354, 355, 356, or 361, a foreign corporation shall not be considered as a corporation unless—

"(1) before such exchange, or

"(2) in the case of an exchange described in subsection (b), either before or after such exchange,

it has been established to the satisfaction of the Secretary or his delegate that such exchange is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes.

"(b) Application of Subsection (a)(2).—Subsection (a)(2) shall apply in the case of a mere change in form in which there is an exchange by a foreign corporation of—

"(1) stock in one foreign corporation for,

"(2) stock in another foreign corporation,

if the corporations referred to in paragraphs (1) and (2) differ only in their form of organization, and if the ownership of the corporation referred to in paragraph (1) immediately before such exchange is identical to the ownership of the corporation referred to in paragraph (2) immediately after such exchange.

"(c) Section 355 Distributions Treated as Exchanges.—For purposes of this section, any distribution described in section 355 (or so much of section 356 as relates to section 355) shall be treated as an exchange whether or not it is an exchange.

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"(d) CONTRIBUTIONS OF CAPITAL TO CONTROLLED CORPORATIONS.—For purposes of this chapter, any transfer of property to a foreign corporation as a contribution to the capital of such corporation by one or more persons who, immediately after the transfer, own (within the meaning of section 318) stock possessing at least 80 percent of the total combined voting power of all classes of stock of such corporation entitled to vote shall be treated as an exchange of such property for stock of the foreign corporation equal in value to the fair market value of the property transferred unless, before such transfer, it has been established to the satisfaction of the Secretary or his delegate that such transfer is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes."

(b) Section 1492 of such Code (relating to nontaxable transfers) is amended—

(1) by striking out the period at the end of paragraph (2) and inserting in lieu thereof a semicolon and "or"; and

(2) by adding at the end thereof the following new paragraph:

"(3) To a transfer to which section 367(d) applies."

(c) The amendments made by this section shall apply to transfers made after December 31, 1967; except that sections 367(d) and 1492 of the Internal Revenue Code of 1954 (as amended by this section) shall apply only with respect to transfers made after December 31, 1970.

I. SUMMARY

Present law provides that, where a foreign corporation is involved in an exchange which otherwise would be a tax-free transaction, tax-free treatment is not available unless prior to the transaction the Internal Revenue Service has made a determination to the effect that the transaction is not being made to avoid Federal income taxes. Under current practice, the determination is made by the issuance of a ruling. H.R. 19686 modifies this provision in two respects. First, the bill provides that the required determination may be obtained after (as well as before) the transaction in the case of a transaction which involves only a change in the form of organization of a second (or lower) tier foreign subsidiary. Second, it is provided that a contribution of property to the capital of a foreign corporation by one or more of the controlling shareholders of the corporation is to be treated as a taxable exchange unless the required determination is obtained from the Revenue Service prior to the transaction.

This bill is reported unanimously by your committee and its enactment is not opposed by the Treasury Department.

II. REASONS FOR BILL

Under present law (sec. 367), an exchange involving a foreign corporation which would otherwise be treated as a tax-free transaction under the corporate organization, reorganization, or liquidation provisions (secs. 332, 351, 354, 355, 356 or 361) does not qualify for tax-free treatment, unless prior clearance is obtained from the Internal Revenue Service. In other words, the taxpayer must obtain a ruling from the Internal Revenue Service prior to the transaction to the effect that the transaction is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes.

This provision is applicable whether the exchange involves both a domestic and a foreign corporation or whether it involves only foreign corporations. An example of the latter situation is the liquidation of a second tier foreign subsidiary into a first tier foreign subsidiary or the merger of two second tier foreign subsidiaries. A transaction involving second tier foreign subsidiaries can have immediate tax consequences to the U.S. shareholders of the first tier foreign subsidiary (under subpart F of the Code) if the transaction is treated as a taxable transaction. This is because the transaction in this case can result in taxable income to the first tier foreign subsidiary which would be currently taxable to the U.S. shareholder as a constructive dividend (under subpart F). Even if the U.S. shareholder is not currently taxable on the income because of the application of one of the exceptions (to subpart F treatment) the classification of the transaction as a taxable transaction might have an eventual effect on the taxation of the U.S. shareholder since it may result in an increase in the earnings and profits of the first tier foreign subsidiary. The earnings and profits of the subsidiary are relevant in determining whether a subsequent distribution to a U.S. shareholder constitutes a dividend. Moreover, in this case this would represent income on which the subsidiary is not likely to have paid any foreign taxes and, therefore, a foreign tax credit may not be available with respect to it.

It has been suggested in the past that a number of the transactions with respect to which an advance ruling is presently required (under sec. 367) are unlikely to involve avoidance of Federal income taxes and, accordingly, the taxpayer should be allowed to obtain the required ruling after the transaction has occurred as well as prior to its occurrence. In this regard, it has been suggested that the time required to obtain an advance ruling often is unduly lengthy in comparison to the time otherwise required to effect a business transaction. It also has been suggested that it is not infrequent for the U.S. parent company to be unaware of formal changes at the second tier foreign subsidiary level.

Although your committee is not prepared at this time to recommend a general revision of the advance ruling requirement (sec. 367), a type of situation has been called to your committee's attention where your committee believes it is appropriate at this time to allow the required ruling to be obtained after the transaction occurs as well as before it occurs. The type of situation called to your committee's attention involves a U.S. parent company which owns a first tier foreign subsidiary which in turn owns a second tier foreign subsidiary. The second tier foreign subsidiary changed its form of organization from one corporate form under the applicable local foreign law to another corporate form. Under U.S. tax law, this transaction is treated as an exchange by the first tier foreign subsidiary of stock in the second tier foreign subsidiary for stock in a new second tier foreign subsidiary. This type of transaction is one which would be treated as a tax-free exchange under our tax law (secs. 354 and 768(a)(1)(F)).

If the required advance ruling were not obtained prior to the transaction, however, any gain on the transaction would be treated as ordinary income. Moreover, because in certain cases income of controlled foreign corporations is attributed on a current basis to the U.S. parent shareholders (under subpart F) any "gain" arising on the exchange may not only be considered ordinary income to the first tier foreign subsidiary but also in turn treated as currently taxable to the U.S. parent company.

Your committee believes that this result is unduly harsh and that the U.S. parent company should be allowed to demonstrate to the Internal Revenue Service after the exchange that it did not have as one of its principal purposes the avoidance of Federal income taxes. This allows the exchange to be treated as a tax-free exchange and thus prevents the tax consequences described above from occurring. In this regard it should be noted that under the Internal Revenue Service's ruling policy the required advance ruling would normally be granted as a matter of course in this type of transaction.

Your committee's attention also was called to the fact that a recent court case held that the advance ruling provision (sec. 367) did not apply to a capital contribution to a controlled foreign corporation where the shareholder did not receive any stock in return. The requirements of this provision, of course, clearly would have been applicable had stock been received by the shareholder. It would appear to your committee, however, that there is as much opportunity for tax avoidance in the case of a capital contribution of property to a controlled foreign corporation where no stock is received in return as in the case where stock is received. In view of this, your committee's bill provides that the advance ruling requirements (of sec. 367) are to apply to capital contributions to foreign corporations by controlling shareholders of the corporation.

III. EXPLANATION OF BILL

For the reasons discussed above, the bill in general modifies the advance ruling requirement which applies in the case of exchanges involving foreign corporations (sec. 367) to allow the required ruling under that provision to be obtained subsequent to the exchange in the case of a transaction involving merely a change in the form of organization of a second or lower tier foreign subsidiary. In other words, the bill provides that the required ruling may be obtained after a transaction involving the exchange by a foreign corporation of its stock in a second foreign corporation (the old form) for stock in a third foreign corporation (the new form) if three requirements are met. First, the transaction must be merely a change in form (of the type which would qualify as a "change of form F reorganization"). Second, the second and third corporations may differ only in their form of organization. Third, the ownership of the second and third foreign corporations must be identical.

The bill also provides that if one or more persons transfer property to a foreign corporation which they control (immediately after the transfer) as a contribution to the capital of the foreign corporation, then the transaction is to be treated as a taxable exchange, unless before the transaction a ruling (under sec. 367) is obtained with respect to the transaction. In other words, the transaction is to be treated as a taxable transaction unless a ruling is obtained before it occurs to the effect that the transaction is not pursuant to a plan having as one of its principal purposes the avoidance of Federal income taxes. Specifically, it is provided that the person transferring property as a capital contribution to a foreign corporation is treated as having exchanged the property for stock of the foreign corporation of equivalent fair market value unless the required prior ruling has been obtained.

In applying this rule, transfers of property to a foreign corporation as paid-in surplus are to be treated as contributions to capital. In addition, where property is transferred to a foreign corporation and stock (or other property) of the foreign corporation of less value than the property transferred is received in exchange, the transaction is to be considered under the bill as consisting of two components: first, a transfer of property in an amount equal to the value of the stock (or other property) received in exchange for the property; and second, a capital contribution of the remainder of the value of the property transferred. Your committee does not intend any inference to be drawn from this treatment as to the treatment of these situations under present law.

In this case an advance ruling (under sec. 367) would have to be obtained with respect to each component of the transaction in order for that component to be eligible for tax-free treatment. For example, assume property worth $100 is transferred to a foreign corporation by a controlling shareholder in exchange for stock of the foreign corporation having a value of $20. In this case the transaction would be treated as an exchange of $20 of the property for the stock and a capital contribution of the remaining $80 of the property. The rules of present law as applied to the exchange component of the transaction would require that an advance ruling (under sec. 367) be obtained with respect to that component if it is to qualify for tax-free treatment. In addition, under the bill an advance ruling would have to be obtained with respect to the capital contribution portion of the transaction if it is to be treated as a tax-free transaction.

The bill provides that in determining whether the shareholders who transfer property to a foreign corporation are in control of the corporation for purposes of applying the rule discussed above, control means the ownership of stock possessing at least 80 percent of the total voting power of the foreign corporation. In determining whether the shareholders have the necessary control for this purpose, stock ownership attribution rules (those contained in section 318 of the Code) are to be applied. Your committee does not intend, however, that any inference be drawn from the fact that attribution rules apply for purposes of the rule provided by the bill as to whether attribution rules either do or do not apply for purposes of applying other provisions of the Code relating to corporate organizations, reorganizations, and liquidations (subchapter C).

The bill also makes a conforming amendment to the provision of present law (sec. 1491) which imposes an excise tax on a capital contribution to a foreign corporation by a U.S. person of stock or securities unless a ruling is obtained from the Revenue Service to the effect that the transaction is not pursuant to a plan having as one of its principal purposes the avoidance of Federal income tax. (This tax is imposed at the rate of 27½ percent on the amount of appreciation in the stock or securities transferred.) Since this provision could also be applicable to a capital contribution which under the bill is included within the scope of the advance ruling requirement (of sec. 367), it is provided that the excise tax is not to apply to capital contributions to foreign corporatons by controlling shareholders with respect to which an advance ruling must be obtained under the rules provided by the bill. This exception is applicable whether or not the required ruling is, in fact, obtained. On the other hand, the exception is not to apply to a capital contribution to a foreign corporation which is not subject to the advance ruling requirement such as where, for example, the contribution is made by a noncontrolling shareholder.

The amendments made by the bill which permit the required ruling to be obtained after the transaction has occurred in the case of certain change of form reorganizations are to apply with respect to transfers made after (including exchanges occurring after) December 31, 1967.

The amendments which provide that contributions to the capital of a foreign corporation are to be treated as taxable exchanges in certain cases unless prior clearance is obtained are to apply with respect to transfers made after December 31, 1970. Your committee does not intend, however, that any inference be drawn from the fact that these latter amendments are not applicable to transfers made before 1971 as to whether capital contributions to foreign corporations are or are not subject to the prior ruling requirement (of sec. 367) under present law.

IV. CHANGES IN EXISTING LAW MADE BY THE BILL, AS REPORTED

In compliance with clause 3 of rule XIII of the Rules of the House of Representatives, changes in existing law made by the bill, as reported, are shown as follows (existing law proposed to be omitted is enclosed in black brackets, new matter is printed in italic, existing law in which no change is proposed is shown in roman):

SECTIONS 367 AND 1492 OF THE INTERNAL REVENUE CODE OF 1954

CHAPTER 1—NORMAL TAXES AND SURTAXES

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"SEC. 367. FOREIGN CORPORATIONS.

[In determining the extent to which gain shall be recognized in the case of any of the exchanges described in section 332, 351, 354, 355, 356, or 361, a foreign corporation shall not be considered as a corporation unless, before such exchange, it has been established to the satisfaction of the Secretary or his delegate that such exchange is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes. For purposes of this section, any distribution described in section 355 (or so much of section 356 as relates to section 355) shall be treated as an exchange whether or not it is an exchange.]

(a) *General Rule.—In determining the extent to which gain shall be recognized in the case of any of the exchanges described in section 332,* *351, 354, 355, 356, or 361, a foreign corporation shall not be considered as a corporation unless—*

(1) before such exchange, or

(2) in the case of an exchange described in subsection (b), either before or after such exchange,

it has been established to the satisfaction of the Secretary or his delegate that such exchanage is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes.

(b) APPLICATION OF SUBSECTION (a)(2).—Subsection (a)(2) shall apply in the case of a mere change in form in which there is an exchange by a foreign corporation of—

(1) stock in one foreign corporation for,

(2) stock in another foreign corporation,

if the corporations referred to in paragraphs (1) and (2) differ only in their form of organization, and if the ownership of the corporation referred to in paragraph (1) immediately before such exchange is identical to the ownership of the corporation referred to in paragraph (2) immediately after such exchange.

(c) SECTION 355 DISTRIBUTIONS TREATED AS EXCHANGES.—For purposes of this section, any distribution described in section 355 (or so much of section 356 as relates to section 355) shall be treated as an exchange whether or not it is an exchange.

(d) CONTRIBUTIONS OF CAPITAL TO CONTROLLED CORPORATIONS.—For purposes of this chapter, any transfer of property to a foreign corporation as a contribution to the capital of such corporation by one or more persons who, immediately after the transfer, own (within the meaning of section 318) stock possessing at least 80 percent of the total combined voting power of all classes of stock of such corporation entitled to vote shall be treated as an exchange of such property for stock of the foreign corporation equal in value to the fair market value of the property transferred unless, before such transfer, it has been established to the satisfaction of the Secretary or his delegate that such transfer is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes.

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CHAPTER 5—TAX ON TRANSFERS TO AVOID INCOME TAX

SEC. 1492. NONTAXABLE TRANSFERS.

The tax imposed by section 1491 shall not apply—

(1) If the transferee is an organization exempt from income tax under part I of subchapter F of chapter 1 (other than an organization described in section 401(a)); or

(2) If before the transfer it has been established to the satisfaction of the Secretary or his delegate that such transfer is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes[.]*; or*

(3) To a transfer to which section 367(d) applies.

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